IPAMS
Independent Petroleum Association of Mountain States

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October 29, 1996

David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165
Denver Federal Center
Denver, CO 80225

Re: Amendments to Transportation
Allowance Regulations for
Federal and Indian Leases
Federal Register: July 31, 1996

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States (IPAMS) submits the following comments to the above-referenced proposed rules. IPAMS is a non-profit, non-partisan association representing over 700 independent oil and gas producers, service/supply companies and industry consultants in the Rocky Mountain region.

Duty to Market

Although couched as a proposal to update the regulations in light of FERC Order 636, these proposed rules are an attempt to increase government revenues at the expense of the lessee by moving the point of valuation ever farther downstream of the lease. In addition to the requirement under the 1988 regulations that the lessee place the lease product in marketable condition at no cost to the government, the MMS now proposes that the lessee be required to give the government a free ride on all "marketing" costs incurred by the lessee or any subsequent purchaser, regardless of how far downstream of the lease the costs are incurred, regardless of how much value is added by these costs and regardless of the fact that a marketable product has already been obtained.

MMS has proposed to amend its rules to impose a duty to market, relying on the case of Walter Oil and Gas Corporation, 111 IBLA 265 (1989). The MMS, then, uses this "duty to market" to justify eliminating certain costs as deductions. Although federal lessees have for the most part always been required to bear the burden of those costs necessary to place production in marketable condition, the concept of marketable condition has historically connoted the physical properties of the gas itself. The MMS has greatly expanded the concept of marketable condition. This newly expanded "duty to market" is actually a means of capturing downstream values.

The Walter case is based on the pre-88 rules and is not factually on point. The applicable law on this issue is stated in Beartooth Oil and Gas Co. v. Lujan, CV92-99-BLG-RWA. The court in Beartooth upheld the principal that the "value to be established is generally the value of marketable gas at the lease" and that the IBLA (and presumably the MMS) "should be concerned with the value of the gas at the lease, and not the value of the gas at some point located off the leasehold."

To assert that the costs a producer incurs in selling downstream are not deductible is to impose a duty to market downstream not at or near the lease. Beartooth supports the opposite conclusion saying that the *"marketable condition* rule does not require the lessee to condition the gas so that it is suitable for secondary or retail markets."

The effect on the small producer selling marketable gas at arm's length at the lease will be devastating. Under the existing regulations this producer knows that the price he receives from his purchaser is the value on which he is obligated to pay royalties. As the court recognized in Beartooth, there is a series of markets between the lease and the burner tip, but the lessee's obligation to place the product in marketable condition refers to the first of these markets. The proposed amendments would change this dramatically by converting the lessee's duty to place gas in a condition suitable for marketing at or near the lease into a duty to market at the burner tip and give the government a free ride on all "marketing" costs incurred in the process.

If the amendments are adopted, the MMS will argue that the price paid at the lease is a reflection of and is "reduced" by all of the costs incurred between the lease and the *final* marketplace; i.e. the point of ultimate consumption. The MMS will then argue that even though the producer sold marketable gas at arm's length at the lease, he must (1) trace the gas all the way to the burner tip, (2) determine each cost incurred by anyone anywhere between the lease and the burner tip, (3) determine whether MMS thinks the cost is a "marketing" expense and, if so, (4) add the cost to the producer's wellhead sales price before computing royalties.

For example, the proposed rules include a declaration that intra-hub title transfer fees for services performed hundreds or even thousands of miles downstream of the lease are not deductible *because it is the duty of the lessee to perform these hub transfer services, and to do so at no cost to the lessor.* If such a duty exists, then, the small producer selling at the lease (or at any point upstream of the hub) who has not provided this service is breaching this duty. Moreover, common sense says that if a purchaser incurs hub fees, the price the purchaser is willing to pay for gas at any point upstream of the hub will reflect and be "reduced" by this expense. The logical result of this unprecedented new duty to perform hub transfer services is that the producer who sells prior to the hub must track his gas beyond the point of sale to the burner tip, determine what, if any, hub title transfer fees were paid by his purchaser (or any subsequent purchaser) and then compute and pay royalties on those fees.

The MMS assumes that there is some "bright line" between true transportation and "marketing costs." However, the decision in <u>Beartooth</u> points out that compression, for example, can be a transportation cost or it can be a cost necessary to place the gas in a marketable condition at the lease. In particular, the proposal not to permit deduction of banking/parking fees, aggregator/marketer fees, cash out penalties, scheduling penalties and imbalance penalties fails to recognize both the lack of control a producer may have over certain fees and penalties and, more importantly, requires the producer to market downstream and absorb all costs and risks of doing so. IPAMS agrees that costs incurred because of gross negligence on the part of the producer should not be deductible, but accepting the benefits of downstream value without allowing deductions for the risks of obtaining that value clearly violates the principals set forth in <u>Beartooth.</u>

Regulatory Certifications and Administrative Costs

IPAMS also disagrees with the certifications made by the MMS that (1) the rule will not have a significant economic effect on small producers, (2) the rule will not interfere with protected property rights, (3) the rule is not a significant one requiring OMB review, (4) the rule does not constitute an unfunded mandate and (5) the rule will not require additional record keeping.

Contrary to these MMS certifications, the proposed rule will greatly increase the lessee's royalty burden by moving the point of valuation from the lease to the burner tip, and then increase the royalty burden even more by permitting the government to share in these enhanced downstream values without paying its share of downstream costs. It is also clear from the proposed rule that the MMS does not rely on a principled basis to determine what is or is not a "marketing" cost. It is therefore impossible for the producer to anticipate what downstream expenses the MMS will disallow (if paid by the lessee) or add to the lessee's "gross proceeds" (if paid by a third party). For example, is odorization a "marketing" cost that must be added to the wellhead value and, if not, how does it differ from an intra-hub title transfer fee or an aggregator's margin? Moreover, the complete loss of certainty and the new need to track gas all the way to the burner tip to look for downstream "marketing" costs will greatly increase the time, effort and record keeping required of the small producer. The time and expense of the administrative appeals and litigation that will inevitably result from the creation of this new, unprecedented and ill-defined duty will also be extensive.

Pipelines are not consistent in how they bill and frequently pipeline companies do not segregate costs, adding not only to the difficulty of compliance but to the likelihood of being second-guessed by MMS in later audits. In addition to the costs associated with the tracking of "marketing" costs and with the proposed retroactivity of this rule, the proposal to require lessees to modify Form MMS-2014 to account for penalty refunds or rate case refunds is administratively burdensome. In fact, the rule as a whole is extremely cumbersome and in no way meets goals of regulatory simplification or streamlining.

Retroactive Effect

MMS proposes to make the changes to the valuation and transportation rules retroactive to May 18, 1992. IPAMS takes strong exception to this proposal. As MMS is well aware, retroactive rulemaking is highly disfavored as a legal matter and tolerated only in a very narrow set of circumstances, none of which are present here.

The retroactive effect is contrary to the weight of law and is a unilateral attempt to change the lease terms of thousands of lessees. Under most federal leases, the Department of the Interior does not have the contractual authority to unilaterally amend the royalty payment obligations established in the lease. There is no basis in law or logic for this violation of existing lease terms. Members of IPAMS relied on existing regulations in reporting and paying royalties with no notice that they might be subject to retroactive rulemaking.

Not only does retroactive rulemaking without prior notice violate principals of fundamental fairness, it creates an excessive administrative burden, particularly on smaller producers, in attempting to recreate data for the past four years. As noted previously it is questionable whether some of this data exists currently, much less can be recreated four years later. To require a small producer to track his gas to the burner tip to see whether anyone in the chain between the lease and the burner tip paid an inter-hub title transfer fee or realized an aggregator's margin is absurd. To require him to go back and do so for every gas sale in the last four and a half years is impossible. It is disingenuous at best to say that this provision is meant "to avoid any potential inequities for those lessees already operating in the FERC Order 636 environment." In fact just the opposite has occurred; producers have relied on the existing law and regulations and it is inequitable to force them retroactively to operate in a totally different regulatory environment.

Conclusion

In conclusion, IPAMS strongly opposes the underlying premise of this proposed rulemaking, which is not supported by the case law, as well as the proposal to make these amendments retroactive. Because MMS' underlying premise is flawed the rule, as a whole, is flawed. Further, the proposed rule presents significant administrative burdens for producers and fails either to simplify or streamline royalty reporting.

IPAMS also supports and incorporates the comments of the Council of Petroleum Accountants and the Independent Petroleum Association of America. Thank you for the opportunity to comment.

Very truly yours,

Barbara L. Widick

Barbara L. Widick
Director of Regulatory Affairs